In the Supreme Court of the United States

OCTOBER TERM, 1974

No. 74-443

LIBERTY LOAN CORPORATION, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The opinion of the district court (Pet. App. A-1 to A-14) is reported at 359 F. Supp. 158. The opinion of the court of appeals (Pet. App. A-15 to A-30) is reported at 498 F.2d 225.

JURISDICTION

The judgment of the court of appeals was entered on May 31, 1974. A timely petition for rehearing was denied on July 19, 1974 (Pet. App. A-31). The petition for a writ of certiorari was filed on October 17, 1974. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether Section 482 of the Internal Revenue Code of 1954 authorizes the Commissioner of Internal Revenue to adjust upwards the unreasonably low interest rates (aver-

aging 1.48 percent) petitioner charged some of its subsidiary corporations without making offsetting downward adjustments in the reasonable rate (5.75 percent) charged to other subsidiaries, when the result is to impute to petitioner a small net profit on its relending transactions.

STATUTE AND REGULATIONS INVOLVED

Section 482 of the Internal Revenue Code of 1954, 26 U.S.C. 482, and the pertinent provisions of Section 1.482 of the Treasury Regulations on Income Tax, 26 C.F.R. 1.482, are set forth at Pet. App. A-32 to A-35, with the exception of Section 1.482-1(d)(2) and (3) of those Regulations, the pertinent provisions of which are set forth in the Appendix, *infra*, pp. 7-9. Rule 52(a), Fed. R. Civ. P., is set forth in the Appenidx, *infra*, p. 9.

STATEMENT

Petitioner is engaged in the consumer finance business both directly, through branch offices, and indirectly, through subsidiary corporations.[1] In the conduct of this business, petitioner borrows substantial sums from unrelated lenders, which it in turn lends to its subsidiaries. This procedure is followed because petitioner's credit rating is better than those of the individual subsidiaries.

During 1961, the taxable year here at issue, petitioner borrowed approximately $110,000,000 at an effective interest rate of 5.55 percent. Petitioner charged its profitable subsidiaries an interest rate of 5.75 percent for the funds relent to them that year; however, it charged its unprofitable subsidiaries little or no interest (the average interest rate charged those subsidiaries was 1.48 percent). As a consequence, the average effective interest rate charged by petitioner to its subsidiaries was 5.55 percent, and peti-

[1]The following statement of facts summarizes the findings of the district court (Pet. App. A-2 to A-8).

tioner accordingly reported no net income from its relending transactions. Petitioner stipulated at trial that unrelated lenders would have charged each of its subsidiaries interest rates in excess of 5.75 percent.

The Commissioner of Internal Revenue determined that the petitioner's income from the loans to the unprofitable subsidiaries was not clearly reflected in its return, and, acting under the authority of Section 482 of the Internal Revenue Code of 1954, he adjusted petitioner's income—and also the incomes of those subsidiaries—to reflect an interest charge of 5 percent on those loans. (Section 1.482-2(a)(2) of the Treasury Regulations on Income Tax, 26 C.F.R. 1.482-2(a)(2), prescribes a 5 percent rate of interest where the rate charged between related taxpayers was less than 4 percent and the taxpayers fail to establish that a rate other than 5 percent is more appropriate.) Although the 5.75 percent interest rate petitioner charged its profitable subsidiaries was less than the fair market interest rate, it was within the "safe haven" range of from 4 percent to 6 percent then prescribed by the regulations, and therefore the Commissioner made no adjustment in petitioner's income on account of its loans to those subsidiaries.

Petitioner paid the tax assessed by the Commissioner and then instituted this refund suit in the United States District Court for the Eastern District of Missouri. The district court, apparently viewing all the subsidiaries together as in effect a single entity and reasoning that petitioner was entitled to relend at its own net borrowing cost, held that the Commissioner was without authority to adjust upwards the interest rates charged to the unprofitable subsidiaries without making offsetting downward adjustments in the rate charged to profitable subsidiaries.

The court of appeals reversed. Noting that "the Commissioner has broad discretion under §482 and his determination will not be upset unless proven by the taxpayer to be arbitrary and capricious" (Pet. App. A-21), the court of

appeals held that the Commissioner had properly adjusted the interest rate on loans to the unprofitable subsidiaries upward to 5 percent and that petitioner was not entitled to offsetting adjustments in the rate charged to profitable subsidiaries, both because the applicable regulations limit offsets to transactions between the same two taxpayers and because a downward adjustment in the 5.75 percent rate "would have the effect of moving those loans even further away from the actual arm's length rate" (Pet. App. A-27).

ARGUMENT

The decision of the court of appeals properly applied the statute and regulations to the facts of this case, and it warrants no further review.

1. Petitioner argues (Pet. 7-9) that the court of appeals exceeded the scope of review permitted by Rule 52(a), Fed. R. Civ. P., and that its construction of Section 482 of the Code conflicts with *Eisner* v. *Macomber*, 252 U.S. 189. Neither argument has merit.

a. The argument with respect to scope of review is based upon petitioner's misconception that the district court's treatment of petitioner's 399 subsidiaries as a single legal entity was a finding of fact. No finding of fact was involved: the district court was simply ruling, as a matter of law, that the Commissioner's discretion under Section 482 to allocate income between a parent corporation and its subsidiaries was limited by a requirement that the subsidiaries be treated as a single entity. That legal ruling directly frustrated the underlying purpose of Section 482, "to prevent corporations within the same corporate family from utilizing their separate corporate structures to diminish the overall tax liability of the corporate family" (Pet.

App. A-21, and it was properly reversed. But even if the district court's determination may be categorized as a finding of fact, it was in any event clearly erroneous; petitioner had made not a "group loan," as petitioner suggests, but a series of separate loans to each subsidiary. As the court of appeals pointed out (Pet. App. A-19):

> The facts stipulated show that the loans were made individually to each subsidiary; the interest rates charged the individual subsidiaries ranged from 0 to 5.75%, depending on the capital status of each company; each subsidiary carried on its balance sheets a note payable to its parent; and each subsidiary filed a separate income tax return, reflecting the individual loan from the parent. Although the parent, for admittedly sound business reasons, may have borrowed a lump sum, nevertheless when it came to relending the monies to the subsidiaries, it is evident that each loan was a separate transaction requiring independent scrutiny by the Commissioner.

b. Petitioner's allegation of a conflict between the decision below and *Eisner* v. *Macomber, supra,* is frivolous. It is based exclusively upon dictum that even if petitioner had, contrary to the facts, made a "group loan," the Commissioner would have been justified in reallocating the interest income between petitioner and its unprofitable subsidiaries because of the increase in petitioner's net worth resulting from the subsidiaries' tax savings. That observation by the court of appeals did not form any part of the basis of its decision and does not warrant review.

2. Contrary to petitioner's claim (Pet. 5-7), the issue presented here is not of general importance. Although there are, as petitioner states, several pending and recently decided cases involving interest income adjustments between

parents and subsidiaries, those cases generally involve the different question, not presented here, whether the borrower must be shown to have income that is directly traceable to the use of the loan proceeds. See, *e.g.*, *B. Forman Co.* v. *Commissioner*, 453 F.2d 1144 (C.A. 2), certiorari denied, 407 U.S. 934; *Kahler Corp.* v. *Commissioner*, 486 F.2d 1 (C.A. 8); *Kerry Investment Co.* v. *Commissioner*, 500 F.2d 108 (C.A. 9).

3. Nor is there any "serious question of law as to whether Section 482 permits the Commissioner to make adjustments of the sort he made here" (Pet. 9). Petitioner's arbitrary underassessment of interest on its loans to unprofitable subsidiaries was a transparent device intended to minimize the corporate family's overall tax burden by shifting income from petitioner to those of its subsidiaries that had net losses. The Commissioner properly invoked Section 482 "to prevent 'artificial shifting, milking, or distorting of the true net incomes of commonly controlled enterprises.' " *Commissioner* v. *First Security Bank of Utah*, 405 U.S. 394, 400. Petitioner's contention that it must be treated as if it derived no net income at all from its relending transactions has no basis either in the statute or in economic or business reality.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

ROBERT H. BORK,
Solicitor General.

SCOTT P. CRAMPTON,
Assistant Attorney General.

WILLIAM A. FRIEDLANDER,
JOHN A. TOWNSEND,
Attorneys.

DECEMBER 1974.

APPENDIX

Section 1.482-1(d)(2) and (3) of the Treasury Regulations on Income Tax, 26 C.F.R. 1.482-1(d)(2) and (3), in pertinent part provides:

> (2) Whenever the district director makes adjustments to the income of one member of a group of controlled taxpayers (such adjustments being referred to in this paragraph as "primary" adjustments) he shall also make appropriate correlative adjustments to the income of any other member of the group involved in the allocation. The correlative adjustment shall actually be made if the U.S. income tax liability of the other member would be affected for any pending taxable year. Thus, if the district director makes an allocation of income, he shall not only increase the income of one member of the group, but shall decrease the income of the other member if such adjustment would have an effect on the U.S. income tax liability of the other member for any pending taxable year. For the purposes of this subparagraph, a "pending taxable year" is any taxable year with respect to which the U.S. income tax return of the other member has been filed by the time the allocation is made, and with respect to which a credit or refund is not barred by the operation of any law or rule of law. If a correlative adjustment is not actually made because it would have no effect on the U.S. income tax liability of the other member involved in the allocation for any pending taxable year, such adjustment shall nevertheless be deemed to have been made for the purpose of determining the U.S. income tax liability of such member for a later taxable year, or for the purposes of determining the U.S. income tax liability of any person for any taxable year. The district director shall furnish to the taxpayer with respect to which the primary adjustment is made a written statement of the amount and nature of the correlative adjustment which is deemed to have been made. * * *
>
> * * * * *

(3) In making distributions, apportionments, or allocations between two members of a group of controlled entities with respect to particular transactions, the district director shall consider the effect upon such members of an arrangement between them for reimbursement within a reasonable period before or after the taxable year if the taxpayer can establish that such an arrangement in fact existed during the taxable year under consideration. The district director shall also consider the effect of any other nonarm's length transaction between them in the taxable year which, if taken into account, would result in a setoff against any allocation which would otherwise be made, provided the taxpayer is able to establish with reasonable specificity that the transaction was not at arm's length and the amount of the appropriate arm's length charge. For purposes of the preceding sentence, the term arm's length refers to the amount which was charged or would have been charged in independent transactions with unrelated parties under the same or similar circumstances considering all the relevant facts and without regard to the rules found in §1.482-2 by which certain charges are deemed to be equal to arm's length. For example, assume that one member of a group performs services which benefit a second member, which would in itself require an allocation to reflect an arm's length charge for the performance of such services. Assume further that the first member can establish that during the same taxable year the second member engages in other nonarm's length transactions which benefit the first member, such as by selling products to the first member at a discount, or purchasing products from the first member at a premium, or paying royalties to the first member in an excessive amount. In such case, the value of the benefits received by the

first member as a result of the other activities will be set-off against the allocation which would otherwise be made. If the effect of the set-off is to change the characterization or source of the income or deductions, or otherwise distort taxable income, in such a manner as to affect the United States tax liability of any member, allocations will be made to reflect the correct amount of each category of income or deductions. In order to establish that a set-off to the adjustments proposed by the district director is appropriate, the taxpayer must notify the district director of the basis of any claimed set-off at any time before the expiration of the period ending 30 days after the date of a letter by which the district director transmits an examination report notifying the taxpayer of proposed adjustments or before July 16, 1968, whichever is later.* * *

* * * * *

Rule 52(a) of the Federal Rules of Civil Procedure provides:

> In all actions tried upon the facts without a jury or with an advisory jury, the court shall find the facts specially and state separately its conclusions of law thereon, and judgment shall be entered pursuant to Rule 58; and in granting or refusing interlocutory injunctions the court shall similarly set forth the findings of fact and conclusions of law which constitute the grounds of its action. Requests for findings are not necessary for purposes of review. Findings of fact shall not be set aside unless clearly erroneous, and due regard shall be given to the opportunity of the trial court to judge of the credibility of the witnesses. The findings of a master, to the extent that the court adopts them, shall be considered as the findings of the court. If an opinion or memorandum of decision is filed, it will be sufficient if the findings of fact and conclusions of law appear therein. Findings of fact and conclusions of law are unnecessary on decisions of motions under Rules 12 or 56 or any other motion except as provided in Rule 41(b).